

FAIR VALUES MEASURED AND DISCLOSED ON HISTORICAL FINANCIAL STATEMENTS

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INTRODUCTION

The Financial Accounting Standards Board (FASB) has identified several objectives of financial reporting. The general objective is to provide useful information for present and potential investors, creditors, and other external users in making rational investment, credit, valuing companies, assessing cash flow prospect, and similar decisions. [FASB: SFAC no. 1, 1978, 28]

To be useful for decision making, accounting information must meet relevance and reliability criteria. A rapid change in economic conditions and advances in information technology of recent years have not only resulted in complexity and difficulty in estimating for uncertainties, but also accelerated various assets to lose some or all of their capacity to recover cost due to obsolescence. Furthermore, the introduction of many new types of financial instruments has raised some problem related to the validity of the current accounting model.

Cost based measurement has an important advantage over other valuation due to its reliability. However, cost-based measurement concept which concern primarily on accruing costs to be matched with revenue is not adequate to keep up with those changes. For example, under generally accepted accounting principles (GAAP) financial instruments must be recorded based on their historical exchange prices, although they do not faithfully represent the economic realities of today's complex instruments.

In addition, cost-based measurement and reporting for financial instruments may cause identical financial instruments recorded at different amounts. Its lack of comparability will decrease the value of financial statements. These situations bring another reason toward financial statements measurement and disclosure based more on fair values.

The accounting profession has responded to the inadequacies of historical cost in several ways. The Securities Exchange Commissions (SEC) has actively encouraged the accounting profession to shift from historical cost-based accounting to a fair value based accounting (FVA). The FASB has not completely confronted the issue of FVA versus historical cost-based, however its current pronouncements clearly indicate that it is heading in this direction. This paper will address both the accounting and auditing aspects of fair value measurement and disclosure for financial instrument and impairment of long lived assets on historical financial statements.

FAIR VALUE ACCOUNTING

The concept of fair value accounting was introduced in 1978. Fair value for an asset is the amount at which it could be exchanged in a current transaction between willing parties under normal conditions. Fair value provides financial statement users with information that can help them assess company accountability, its financial position, and condition.

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Some arguments supporting the use of fair value accounting are: (1) fair value accounting is more accurate and relevant than historical cost accounting in measuring a firm's current ability to redeploy its resources; (2) FVA reflects changes in financial conditions resulting from fluctuations in interest rates; and (3) FVA reduces the alleged gains trading problem of selling high-quality assets to realize gains while retaining poor-quality assets to avoid recognizing losses [Cornett, M.M., et al., 1996, 119-154]. Others argue that the use of FVA create the following problems: (1) FVA increases volatility of reported earnings and capital; (2) fair value measures are not objective; and (3) infeasibility of FVA implementation within the existing accounting framework.

Although users oppose replacing the current historical cost-based accounting model with fair value accounting model, they view that fair value information useful for particular types of assets and liabilities in certain types of industries [Rosenfield, 1994, p.21]. Furthermore, due to rapid changes in market demand and information technology, fair value information will continue to grow in its importance, and obtaining fair value information will continue to become easier and less costly.

FAIR VALUE ACCOUNTING FOR FINANCIAL INSTRUMENTS

In December 1991, the FASB issued Statement no. 107, *Disclosure about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), which requires all entities to disclose the fair value of certain financial instruments for which it is practicable to estimate fair value [Auditing Accounting Estimates, Sec. 342, 1993, 101]. The FASB Statement no. 115, *Accounting for Certain Investments in Debt and Equity Securities*, expands the use of fair value accounting on financial instruments and restricts some debt securities that can be carried at amortized cost. This statement applies to all entities except for not-for-profit organizations. This statement supersedes the SFAS 12, *Accounting for Certain Marketable Securities*, changes the accounting for investments, and alters the way investments are categorized.

According to the SFAS 115, Investment in debt and equity securities must be classified into: 1. held-to-maturity securities, 2. trading securities, and 3. available-for-sale securities. Each category has different accounting treatments and financial statement implications. Held-to-maturity debt securities must be carried on amortized cost, while debt and equity securities that are classified as trading securities are reported at fair value with unrealized gains and losses included in earnings. Debt and equity securities classified as available for sale securities are reported at fair value with unrealized gains and losses reported in a separate component of shareholders' equity.

All transfers of securities from one category to another category must be accounted for at fair value on the transfer date. Fair values for the debt and equity securities are quoted at market prices in active markets at that date. According to Nurnberg and Dittmar (1996), when fair value information of these assets are not available, estimates fair value should be based on the best available information, such as prices for similar assets or the results of valuation techniques.

The use of fair value accounting for all debt securities will promote consistency and eliminate complexities. As a result, it will generate uniformity of the accounting treatment authoritative literature on investments in debt securities across different industries. In addition, using fair value measurement and disclosure will increase the neutrality of historical financial statements. SFAS 115 is a long overdue step in a direction that hopefully will lead to more relevant and representational faithful financial statements.

The SFAS 115 might create a problem when securities that will result in gains are sold, while securities that probably will result in losses are reported as held to maturity using the amortized cost method. However, the advantages of fair value accounting for debt securities, particularly in terms of greater information relevance, outweigh its disadvantages and improve financial reporting.

FAIR VALUE ACCOUNTING FOR LONG LIVED ASSETS

As another pronouncement toward fair value accounting, the FASB released statement no. 121, *Accounting*

for the Impairment of Long Lived Assets and for Long Lived Assets to be Disposed of. The FASB Statements no. 121, applies to long-lived assets, certain identifiable intangibles and goodwill related to be held and used and long-lived assets and certain identifiable intangibles to be disposed of. Under this statement, management are responsible for considering whether an asset is impaired. Management should implement accounting policies and procedures to identify and signal for other possible impairment indicators based on company's operating environment.

If there is an indication that the carrying amount of an asset to be held and used may not be recoverable, management should test for impairment by estimating future cash flows from its use and eventual disposal. An impairment loss, equals to the difference between the carrying amount and the asset's estimated fair value, must be recognized when carrying amount exceeds undiscounted future cash flows.

However, when market information is not available or for some reasons fair values are difficult or costly to obtain, estimated fair value of the asset can be measured by discounting the expected future cash flow at an appropriate discount rate. These estimates are based on judgments regarding future expected loss experiences, current economic conditions, technological changes, and other factors. In estimating future cash flows management should consider all incremental cash flows—recurring and nonrecurring. The appropriate discount rate is a discount rate commensurate with the risk involved in similar investments.

The FASB statement no. 121 does not prescribe the time frame when discounting estimated cash flows period for depreciable assets, the period should less be than or equal to the remaining useful lifes. Estimating cash flows for short period including a residual value may be preferable to estimating cash flows for longer periods. For measurement purposes, accountant may refer to the Proposed Statement of Financial Accounting Concepts, *Using Cash Flow Information in Accounting Measurements*, June 1997.

AUDITING ACCOUNTING ESTIMATES

One of the initial findings of AICPA *Issues Report on Information Needs of Investor and Creditors* states that users of financial reporting believe that audited information has value because auditors provide independent assurance of the reliability of amounts reported and accompanying disclosures. Generally accepted auditing standards (GAAS), requires the auditor either to obtain sufficient and competent evidence to reach judgment on compliance with GAAP, or to state that a scope limitation exists.

Implementation of fair value measurement and disclosure on historical financial statement requires an estimation process, which potentially generates estimation error and increases audit risks. Under the SAS 47, *Audit Risk and Materiality in Conducting an Audit*, auditors should consider such risks when performing an audit of financial statements. Additionally, in the SAS no. 57, *Auditing Accounting Estimates*, auditors should make sure that management's major assumptions underlying the analysis of future cash flows are adequately supported and documented as to rationale and reasonableness [Nurnberg and Dittmar, 1996]. Completeness and correctness of fair value information must be considered. If auditors encounter complex or subjective matters potentially material to the financial statements they may use the work of a specialist to obtain competent evidential matter. (AICPA, SAS 73, *Using the Work of a Specialist*, 1994).

According to the SFAS 121, auditors should examine company minutes and other evidence or indicator regarding impairment of long-lived asset. If no such indication are found, impairment testing and extensive audit testing are not required.

AUDITING ACCOUNTING DISCLOSURES

Some companies may disclose information required by Statement no. 107, 115, and 121, or disclose volunta-

rily the fair value of assets and liabilities. When auditing management's estimates of both required and voluntarily fair value information, auditors are responsible for obtaining sufficient competent evidential matter to reasonably assure that the valuation principles are acceptable, consistently applied, and supported by the underlying documentation, and that the method of estimation and significant assumptions used are properly disclosed. If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles [Auditing Accounting Estimates, 1993, p. 101].

When voluntary information is presented in addition to the required information, the AU Sec 9342.04 state that the auditor may audit the voluntary information only if both the following conditions exist: (1) the measurement and disclosure criteria used to prepare the fair value financial information are reasonable, and (2) competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements and disclosures. However, if the auditor does not engaged to audit voluntary disclosure or both conditions in AU Sec 9342.04 can not be met, the voluntary disclosure should be labeled "unaudited" and auditor should give disclaimer opinion on that part. The auditing guidance related to each of these alternatives is presented in figure 1 (adapted from Auditing Accounting Estimates: Auditing Interpretations, 1993).

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CONCLUSION

Fair value accounting is a new reporting requirement and has numerous calculations and definitional requirements. The understandability of measurement methods and fair values would be improved by more detailed explanations of fair value methods used, more detailed breakout of asset, liability, and off-balance-sheet financial instrument classifications, and more neutral statements. Without adequate descriptions, users of financial statements may draw inappropriate conclusions as to how specific fair value is determined, and may mislead their decisions. Inadequate disclosures of such details will reduce the usefulness of financial statements.

Fair value for financial instruments would be more objective and relevant than historical cost, because it is based on an estimate of the current value of assets. Relevant information help users predict the ultimate outcome of past, present, and future events (*predictive value*), or confirm prior expectations (*feedback value*).

Management or the independent auditors, or both, should warn users about the possibility of the assets to be disposed of, and disclose them earlier. These information will reduce surprise and shock, unless the declines are sudden, or unexpected. Since fair value measurement and disclosure are new issues, the accounting profession should further train its members on the measurement techniques to maintain their competence.

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Figure 1. Auditing Guidance for Fair Value



